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By Electronic Delivery

Louise L. Roseman
Director
Division of Reserve Bank Operations and Payment Systems
Board of Governors of the Federal Reserve System
Washington, D.C. 20551

Re: Regulations to Implement Dodd-Frank Debit Interchange Provisions

Dear Ms. Roseman:

This letter is on behalf of a number of institutions that participate in the debit card industry in this country. We have been working together to address the debit interchange implementation challenges surrounding the recent Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act") amendments to the Electronic Fund Transfer Act ("EFTA"). As you know, section 920 of the EFTA, as amended, directs the Board of Governors ("Board") to issue regulations relating to debit interchange fees and the routing of debit transactions ("Section 920"). We recognize that Section 920 raises challenging issues related to rate making that differ from the regulatory issues that the Board frequently addresses.

We have been conducting a data collection effort on issuer costs that builds on the Board's survey. This effort is ongoing, but we believe that we are developing a compilation of accurate data that is reasonably comparable across institutions. Our efforts to date show that there are significant differences among issuer cost data. In many cases, the differences in our cost data appear to be a function of different interpretations of survey questions. Nevertheless, when these differences are accounted for, there still appears to be significant variability among issuers. There are many factors that contribute to cost variability some of which include portfolio volume and mix. This wide variability of costs suggests that the rate structure that the Board adopts could have differing effects across the spectrum of financial institutions. In addition, in reviewing 2009 issuer data, it has also become apparent that these data cannot provide an accurate picture going forward because of other regulatory changes, including the potential exclusivity and routing requirements under Section 920(b) of the EFTA, which may increase issuer costs. In addition, we note that, while the Board collected

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information on revenues from penalty fees, the Act does not provide for consideration of these fees as revenue offsets to whatever interchange rate structure the Board establishes. Moreover, these fees have been sharply limited beginning in July of 2010, and some financial institutions do not charge debit overdraft fees.

Finally, further analysis and refinement of the data that we are our developing and our evolving understanding of likely market dynamics may lead to additional or different views on the implementation of Section 920. In the interim, we offer the following letter to assist the Board staff in its thinking about these issues so that the Board can arrive at a workable and balanced approach to implementing Section 920. As discussed in more detail below, this letter addresses two broad issues that will confront the Board in implementing Section 920: (1) the types of debit card issuer costs and return on investment that should be considered “reasonable and proportional” to debit card transactions; and (2) a framework, or architecture, for debit interchange fees.

“Reasonable and Proportional” to Issuer Costs

Section 920(a) of the EFTA, as amended, provides that “[t]he amount of any interchange transaction fee that an issuer may receive or charge with respect to an electronic debit transaction shall be reasonable and proportional to the cost incurred by the issuer with respect to the transaction.”¹ In this regard, the Board is directed to prescribe rules that “establish standards for assessing whether the amount of any interchange transaction fee . . . is reasonable and proportional to the cost incurred by the issuer with respect to the transaction.”² In so doing, the statute states that the Board should distinguish between “the incremental cost incurred by an issuer for the role of the issuer in the authorization, clearance, or settlement of a particular electronic debit transaction” and “other costs incurred by an issuer which are not specific to a particular electronic debit transaction.”³ The statute specifies that the “other costs” that are not specific to a particular electronic debit transaction may not be considered a “cost incurred by the issuer with respect to the transactions.”⁴

The Statutory Language

Under whatever rate framework the Board ultimately adopts, the Board will need to identify the types of issuer costs that may be included within that framework and that will make up permissible debit interchange fees. In this regard, we believe it is useful to focus on the actual language of the statute. The statute’s clear focus is that the permitted issuer costs are limited to those that are related to debit card transactions. For example, the statute states

¹ 15 U.S.C. § 1693o-2(a)(2).

² 15 U.S.C. § 1693o-2(a)(3)(A).

³ 15 U.S.C. §§ 1693o-2(a)(4)(B)(i), (ii).

⁴ 15 U.S.C. § 1693o-2(a)(4)(B)(i).

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that the amount of any interchange fee that an issuer may receive with respect to a debit transaction must “be reasonable and proportional to the *cost incurred by the issuer with respect to the transaction*.” It is important to note that this language does not indicate that a debit interchange fee for a given transaction must be limited solely to the relevant costs associated with the transaction; instead, the language simply requires that there be a “reasonable and proportional” relationship between the two. Moreover, the statute directs the Board to distinguish between “the incremental cost incurred by an issuer for the role of the issuer in the authorization, clearance, or settlement of *a particular electronic debit transaction*” and “other costs incurred by an issuer *which are not specific to a particular electronic debit transaction*.”

These two concepts (“incremental costs” and “other costs”) are not all inclusive. A narrow reading of the term “incremental” may exclude costs that are nevertheless specific for a particular electronic debit card transaction. We believe that the statutory language does not require such a reading. More specifically, we do not believe that the statute requires the Board to limit permissible issuer costs to those that are incremental in connection with the authorization, clearance and settlement of debit transactions. Instead, we believe that the only limitation actually imposed by the statute is that “other costs” that are not specific to debit card transactions may not be included. As a result, we believe that the Board has the discretion under the statute to consider issuer costs other than incremental costs for authorization, clearance and settlement, narrowly defined, so long as those costs are specific to debit card transactions.

Issuer Costs Specific to Debit Transactions

Debit card issuers incur a wide variety of costs in connection with their debit card operations. For example, an issuer’s “total” costs for its debit card program include: (1) costs that vary with the volume of debit card transactions (variable or incremental transaction costs), such as certain processing costs; and (2) costs that are related to debit card transactions, but that do not vary significantly due to an additional transaction, such as capital investment costs and the costs of printing cards and mailing statements. Nonetheless, any cost incurred by an issuer with respect to its debit card program facilitates its debit card transactions in some manner. Said differently, if an issuer did not incur its various costs, some or all aspects of its various debit card transactions could not be processed. At the same time, there are other costs associated with transaction amount payments, such as check and ACH transactions, that are not related to a particular debit card transaction. In many cases, costs will be related both to particular electronic debit card transactions and to other transactions, and it may be necessary to allocate some costs to electronic debit card transactions and some to other transactions. For example, a “but for” cost of debit card transactions includes providing the cardholder with a statement with respect to the transactions; however, statement costs will also relate to other transactions and, therefore, the total statement costs must be allocated among transactions on some reasonable basis.

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We believe that the Board will want to include “nonvariable” costs in the calculation of reasonable and proportional interchange transaction fees under Section 920 for several reasons. First, failure to include all costs of electronic debit card transactions in interchange transaction fees may lead debit card issuers to cross-subsidize these transactions from other deposit account revenues. Whether or not such cross-subsidies would take place may vary across institutions. If this cross subsidization did not occur, some electronic debit card transactions may not be offered by some institutions. A reduction in the availability of electronic debit transactions would seem to be inconsistent with the perceived need to regulate the interchange applied to these transactions. Regulation of electronic debit transactions carries with it the inherent judgment that these transactions are important transactions to the businesses accepting the transactions or the business would refuse to accept them in the first place. Accordingly, any regulation of electronic debit transactions should retain the economic viability of these transactions.

Second, if cross subsidization of electronic debit transactions did not take place and the full costs of these transactions were explicitly charged to debit cardholders (a structure that would differ markedly from price structures for check, ACH, ATM and cash transactions), the costs to consumer cardholders for these transactions could increase in a way that is inconsistent with the statutory admonitions to the Board in section 904(a)(2)(d)(3) of the EFTA concerning preserving competition in the provision of electronic banking services (*e.g.*, ACH vs. debit card transactions) and compliance costs and consumer protection. This interchange structure also would have the effect of discouraging electronic debit transactions, as opposed to check and cash transactions.

Third, even if the Board felt that it should interpret Section 920 narrowly to limit its consideration to “incremental costs,” we believe that the Board will want to recognize that, for several reasons, “incremental costs” cannot practically be viewed as the computer and telecommunications processing cost of the next electronic debit card transaction handled by an issuer enjoying significant economies of scale. For example, the costs to authorize, clear and settle a transaction necessarily include the costs incurred in reaching final settlement of these transactions. These costs include not only the data processing costs of processing and posting a transaction that settles without incident or dispute, but also the costs of resolving disputes raised by cardholders who may question whether a particular transaction is authorized. In other words, the incremental costs of a transaction necessarily depend on which “incremental” transaction is considered.

Fourth, in its most literal sense, incremental costs will differ transaction by transaction, depending on the network, the issuer, the type of transaction, the routing of the transaction and so on. Accordingly, any incremental cost identified by the Board for regulatory purposes under Section 920 necessarily will be an average of some number of transactions. Not only will this average include disputed, as well undisputed, transactions

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and transactions involving different networks and issuers, but it will also inherently include different transactions over time. For example, different transactions at different times will use different portions of fixed resources, depending on the other transactions competing for those resources during the measurement period. Similarly, different transactions at different times will be subject to different costs because of changes in the costs of the services required to authorize, clear and settle the transactions. Accordingly, any “incremental” cost must, as a practical matter, reflect an average of the costs of different transactions. A difficult issue in arriving at cost numbers will depend on how that average is computed. Any reasonable average should be designed to capture cost differences over time, as well as cost differences across transactions.

Fifth, as discussed below, the costs of providing electronic debit card transactions should include a reasonable rate of return on the issuer’s investment in its debit card operations. Debit card issuers must make significant investments in their debit card operations. These investments must yield a market rate of return or the funds will simply not be available for investment.

“Reasonable and Proportional” and Return on Investment

The requirement that interchange rates must be “reasonable and proportional” should include a component for return on investment, regardless of whether or not that return is viewed as a “cost.” The concept of reasonable and proportional is substantially similar to the requirement in traditional federal rate making that regulated rates be “just and reasonable.” Federal rate making typically allows for a reasonable rate of return on investment. For example, the Federal Power Act provides the Federal Energy Regulatory Commission (“FERC”) with the authority to establish rates that may be charged for wholesale power and transmission of power in interstate commerce.⁵ Similarly, the Natural Gas Act provides FERC with the authority to establish rates for pipelines that transport natural gas in interstate commerce.⁶ In addition, the currently effective remnants of the Interstate Commerce Act grant FERC the authority to regulate pipelines that transport oil in interstate commerce.⁷

The traditional form of price regulation used in most or all of these industries is cost-based regulation, or “cost of service” regulation. Under this type of regulation, a utility is allowed to set rates based on the cost of providing service to its customers, including the right to earn a limited profit or return on investment. Each of the acts above charges FERC with assuring that the regulated prices are “just and reasonable” for customers, a term of art around which a considerable body of law has developed. The Supreme Court has described just and reasonable rates in this context as those that allow the utility the opportunity to

⁵ 16 U.S.C. § 791 *et seq*

⁶ 15 U.S.C. § 717 *et seq*.

⁷ 49 U.S.C. § app. 1 *et seq*. (1988).

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recover its costs and earn a return “commensurate with returns on investments in other enterprises having corresponding risks.”⁸

In its most simplistic form, this means that a utility is entitled to establish a rate that will allow it to recover its actually incurred operating and maintenance costs, an annual return of a reasonable amount of its capital investment in the utility assets in the form of depreciation and a reasonable return on its capital investment as calculated by a prescribed methodology. FERC’s normal method of calculating that return is to use the Discounted Cash Flow method for a number of similar companies (*Hope*’s “enterprises having corresponding risks”) to calculate a range of return on equity, and then taking a number, often the mid-point, in that range for calculating the rate of return in question by combining it with the regulated company’s actual debt-to-equity ratio and cost of debt figures. Normally the costs and return data are obtained for a recent time period (the “test period”) along with a projection of the throughput or consumption of the service or commodity in question, and then a forward-looking rate is derived by dividing the total costs (including the return, or profit) by the throughput or consumption projection.

Accordingly, while Section 920 addresses interchange fees in terms of “electronic debit transactions,” this term must be viewed as an average of some number, or grouping, of different types of debit transactions. We do not believe that Section 920 requires this grouping to be issuer specific. That is, cost recovery need not be, and in practice cannot be, measured efficiently on an issuer-by-issuer basis. We believe that groupings at the network level are most appropriate and would be most efficient because issuers do not in practice set interchange transaction fees (except for those issuers that also act as networks); rather, these fees are set by networks and because issuers, in some case, accept transactions from different networks.

Possible Frameworks for Debit Interchange Fees

In order to implement the debit interchange provisions of Section 920, the Board must determine how to incorporate permissible issuer costs into an interchange framework that will be used to determine compliance with the interchange limitation. In essence, the Board must engage in a ratemaking, similar to, for example, the FERC rate making in the energy industry. In this regard, the Board has a variety of options in order to implement the interchange provision. For example, the Board could:

- (1) set a general interchange “cap” that provides one or more specific interchange rates that an issuer may receive (“Cap Model”);
- (2) establish the specific interchange rates that an issuer may receive for specific types of transactions (“Specific Rate Model”);

⁸ See *Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944).

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- (3) define the types of issuer costs that may be included in a permissible interchange fee and then allow the payment card networks to establish the rates at a transaction level (“Individual Cost Model”); or
- (4) establish an average effective interchange rate that an issuer may receive for all debit transactions and then permit a payment card network to establish various interchange rates so long as the effective average of the rates ultimately charged through the network adheres to the Board-established overall average effective interchange rate (“Average Effective Model”).

We believe that the Average Effective Model is most appropriate. It would have the effect of reducing overall effective debit interchange rates, while recognizing issuer costs for debit transactions plus a reasonable return on investment. Moreover, the Average Effective Model would not only reduce interchange costs to businesses accepting electronic transactions and provide a simplified framework for the industry, but would also provide the Board with a framework that would be relatively easy to monitor, update and enforce.

Each of the other Models described above, however, likely would present significantly more difficulties. For example, under the Cap Model, unless the Board set the cap or caps to compensate issuers for the types of transactions in which the issuers incur the greatest cost, issuers would receive interchange fees for some types of transactions that would be less than the permitted costs incurred by the issuers with respect to those transactions. This would discourage more costly transactions in which the interchange fee would not recover the costs associated with those transactions. Declining or unwinding these transactions could adversely affect merchants because electronic debit transactions might not be authorized for more costly merchant environments. In order to recover the costs associated with transactions where the costs are greater than the interchange fee, issuers may charge interchange fees up to the “cap” for those transactions where the costs are less than the cap. Even with this cross subsidization, higher cost transactions would be discouraged because this approach would not recognize the significant differences in cost to serve specific merchant segments. Nonetheless, merchants operating in lower cost environments likely would subsidize those merchants operating in higher cost environments.

In order to address the difficulties of the Cap Model, the Board could instead choose to establish specific interchange rates that an issuer may receive or charge for specific types of transactions (Specific Rate Model). Inevitably, this process would lead to similar problems as the Cap Model. The Specific Rate Model also may require far more detail than the Board has collected in its issuer and network surveys, as rate setting would need to account for differences in cost that occur at a transaction level. The Board would have to devote substantial resources to track and price transaction types based on costs. There would also be variation in cost by issuer, implying that interchange should vary by issuer. As mentioned above, this would raise the issue of accounting for differences in cost by type of

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transaction when many of the ultimate costs are not fully known until the full life cycle of a transaction (including resolution of any disputes) is complete.

The Board also could define the types of issuer costs that may be included in a permissible interchange fee and then allow the payment card networks to establish the rates (the Individual Cost Model). Although this approach would avoid the difficulties associated with setting a specific rate cap or caps, it would be far more cumbersome for the Board to enforce and for issuers and networks to comply with. While the Board would specify the relevant cost categories, these cost categories likely would vary from issuer to issuer. As a result, in order to determine whether interchange fees were appropriate, the Board would have to examine the issuer's cost structure for some relevant period preceding the period in which the fees were charged, as opposed to the other approaches in which the Board could enforce by, for example, confirming the average or maximum rates of interchange fees that an issuer received. Adopting an approach in which interchange may vary by issuer would also present operational difficulties for acquirers because their existing billing systems do not take into account the identity of the issuer when forecasting interchange, setting merchant discount rates or even billing merchants.

Unlike the other Models, we believe the Average Effective Model would be the most flexible for issuers and payment card networks and would likely be easier for the Board to implement and enforce. In this regard, the Board would establish an "average effective" interchange rate that an issuer may receive for all debit transactions and then permit the payment card network to establish various rates based on different factors, such as merchant type and authorization mechanism, so long as the overall average effective rate charged by the network is no greater than the Board-established average effective interchange rate over a defined period. As you know, interchange rates are established on a market-based approach. Current interchange rates vary by network, by transaction type and by risk factor, such as whether the card is present or the type of authorization method. In this regard, the Average Effective Model offers the benefit of providing the payment card networks with the flexibility to set interchange rates to control for risk (*e.g.*, fraud), but also to provide incentives to merchants to adopt more efficient processing solutions or safer technologies. Moreover, within the permitted average effective rate, the payment card networks and issuers would have the flexibility to adopt varying rates in order to address the cross subsidization issue discussed above. This Average Effective Model would be similar to the approach adopted in Australia, where the Reserve Bank of Australia has established a consistent standard around the general level of debit rates, but individual rate setting is left to the payment networks.

As noted above, implementing the Average Effective Model at the network level, as opposed to the issuer level, would be most practical and efficient. We believe that this approach is the most practical and efficient for a number of reasons, including the fact that the payment card networks currently set the interchange rates for debit transactions over

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those networks, and would be the least disruptive to the industry and preserve the most flexibility for future innovation.

The Average Effective Debit Interchange Rate Framework

The first step in implementing the Average Effective Model would be for the Board, as described above, to identify allowable issuer costs that can be included in a permissible debit interchange fee. Using cost data and transaction volumes from the issuer and network surveys, the Board would then calculate an average effective debit interchange rate for the debit card industry generally that is based on these “allowable” costs (the “Average Effective Debit Interchange Rate”). In computing the Average Effective Debit Interchange Rate, it is likely that, due to economies of scale, a simple average would result in more equitable rates across institutions of different sizes. This Average Effective Debit Interchange Rate would not be specific to any given payment card network, and could be expressed, for example, in terms of basis points of transaction amount.

This Average Effective Debit Interchange Rate would then function as a safe harbor for an issuer operating on or as a payment card network. That is, a debit card issuer operating on or as a payment card network would be deemed in compliance with the statute’s interchange limitation if the average, systemwide effective debit interchange across all domestic debit transactions on that network is maintained at the Average Effective Debit Interchange Rate over a to-be-defined time period (e.g., four calendar quarters). Under this approach, a network could set different rates based on merchant size, merchant segment, acceptance channel (e.g., card present vs. card not present), processing requirements or other factors, so long as the network’s overall effective debit interchange rate is maintained at the Average Effective Debit Interchange Rate. Similarly, this approach would allow a payment card network to establish individual debit interchange rates using fixed amounts, variable amounts or a combination of the two. The Board would need to periodically update the Average Effective Debit Interchange Rate as the underlying aggregate issuer cost profiles change over time.

This approach is generally consistent with how Visa and MasterCard currently manage domestic debit interchange in Australia under the Reserve Bank of Australia’s required methodology. In addition to implementing the requirements of Section 920, this approach places the burden of determining and managing individual rates on the networks (rather than the Board), while preserving the ability of networks to use interchange to provide stakeholder incentives to grow participation in, and strengthen the quality of transactions being processed over, a given network.

Fraud Adjustments

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Section 920 also provides that the Board may permit issuers to receive a fraud-related adjustment (*i.e.*, increase) to the debit interchange fees that they receive. Specifically, the Board may allow a fraud adjustment if: (1) the adjustment is “reasonably necessary to make allowance for costs incurred by the issuer in preventing fraud in relation to electronic debit transactions involving that issuer;” and (2) the issuer complies with the Board’s fraud standards.⁹ Although there are a variety of approaches to implementing a fraud adjustment factor, we believe that a simple, flexible approach would be more effective and readily administered and enforced. For example, the Board could treat issuer fraud prevention costs and fraud losses the same as the other issuer costs discussed above. That is, the Board could incorporate these fraud costs into the Average Effective Debit Interchange Rate. Under this approach, all issuers would receive the fraud “adjustment,” which would provide a market-based incentive to all issuers to reduce fraud. In turn, the Board would issue general, risk-based fraud prevention standards that each covered issuer would be required to comply with. Specifically, each issuer would be required to comply with the Board’s fraud prevention standards, and each issuer would receive a fraud “adjustment” to its debit interchange fees that the Board would incorporate into the Average Effective Debit Interchange Rate in the same manner as the issuer transaction costs.

For example, the Board’s fraud prevention standards could be modeled on the information security standards issued by the Board and the other federal banking agencies to implement Section 501(b) of the Gramm-Leach-Bliley Act (“GLBA”). Under the GLBA information security standards, a bank must implement a risk-based information security program that includes, where appropriate, various information security measures identified by the agencies that are designed to protect customer information. A GLBA-like approach would provide a number of benefits. First, it would allow each covered issuer to tailor its fraud prevention program based upon the nature and scope of its actual debit card practices. Moreover, this approach would provide both the Board and covered issuers with the flexibility to adapt with changes in technology, as well as changes in fraud activities and techniques. A more detailed approach that prescribed specific controls that all issuers must adopt would provide issuers with far less flexibility in order to adapt to changing technologies and fraud patterns, and the Board would need to continually monitor and update the standards as appropriate.

Ongoing Monitoring and Enforcement

In order to adopt the Average Effective Model, the Board would need procedural mechanisms to assist the Board in monitoring, updating and enforcing the Average Effective Debit Interchange Rate. We believe that the following procedures could easily be enforced by the Board, and would assure that covered issuers would receive or charge debit interchange fees that are based on the Average Effective Debit Interchange Rate over time.

⁹ 15 U.S.C. §§ 1693o-2(a)(5)(A)(i), (ii).

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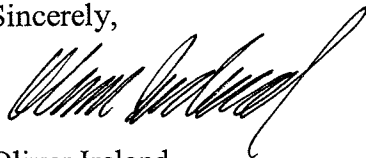
On an annual basis, each payment card network would file with the Board its current debit interchange rate structure, report on the amount of debit interchange and volume processed over its network during the previous year, and indicate whether its average, system-wide effective debit interchange across all domestic debit transactions was at or below the Average Effective Debit Interchange Rate for that year. A network would report both from the perspective of what acquirers or merchants paid and what issuers received, so that the Board could confirm compliance from both sides.

If a network's actual effective debit interchange rate exceeded the Average Effective Debit Interchange Rate during the measurement period, the network could be obligated to promptly take steps to bring the actual effective debit interchange rate into line with the Average Effective Debit Interchange Rate. These steps could include rate changes or other adjustments, at the Board's discretion. In the event further corrective action was warranted, the Board could instruct the network to reduce some or all of its debit interchange rates so as to lower the network's effective debit interchange rate, and, potentially, other measures that the Board deems appropriate. These steps could be coupled with quarterly reporting to track the relationship between the network's actual effective debit interchange rate and the Average Effective Debit Interchange Rate. Any enforcement mechanism should recognize that a change in the mix of transactions can change not only the actual effective debit interchange rate, but also the issuers' costs over the measurement period. Those costs, however, may not be fully known until the next cost survey. Remedial actions should be reserved for cases where it is clear that any excess in the actual effective debit interchange rate above the Average Effective Debit Interchange Rate does not also reflect an increase in issuer costs.

* * * *

We appreciate the opportunity to comment on this important matter. If you have any questions concerning these comments or if we may otherwise be of assistance in connection with this matter, please do not hesitate to contact me, at (202) 778-1614.

Sincerely,



Oliver Ireland
Morrison & Foerster LLP